



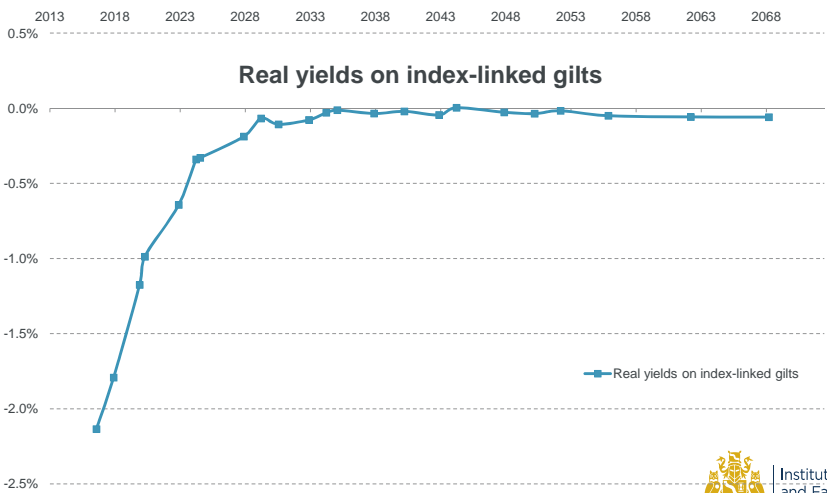
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Financial repression – what does it mean for savers & investors

Financial repression working party of the
Finance & Investment Board

January 2014

Financial repression in action...



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Financial repression in action...

Savers 'condemned to £33bn loss' by Bank of England

Daily Telegraph, August 2013

The £170bn secret raid on your savings: How keeping rates at a record low is a government ploy to pay off its debts

thisismoney.co.uk, August 2013

The elderly must suffer low rates so the young can pay down their debts

Daily Telegraph, July 2013

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What is Financial Repression?

Shaw and McKinnon (1973)

- Distortion by government of domestic capital markets
- Particularly to channel funds to themselves, that, in a deregulated market, would go elsewhere

Reinhart and Sbrancia (2011)

- Explicit or indirect caps or ceilings on interest rates
- Direct lending to govt. from captive domestic audience
- Regulation of cross-border capital
- Tighter connections between governments and banks

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What is Financial Repression?

- **Implemented by:** Macro-prudential regulation
 - “Goodbye financial repression, hello market crash”
- **Evidenced by:** Negative real yields
- **Impact:** A tax on savers
 - Paid to borrowers – including government



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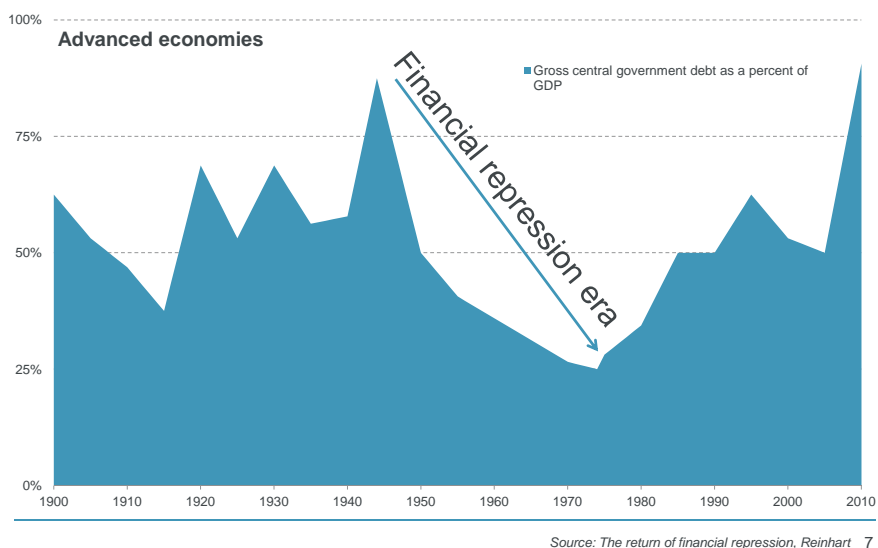
How can debt to GDP be reduced

1. Economic growth
2. Austerity and fiscal adjustment
3. Outright defaults or restructuring
4. Surprise burst in inflation
5. Steady dose of financial repression + steady inflation



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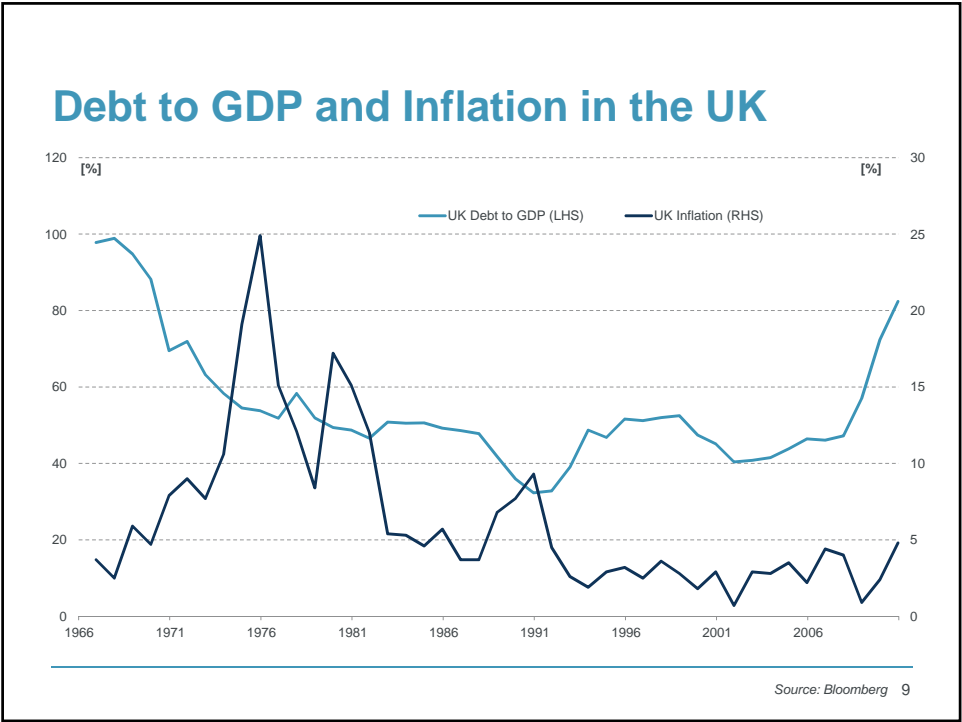
Gross government debt as a % of GDP



Financial repression “tax” estimates

Country	Period	% GDP p.a.	% of years with -ve real yield
Argentina	1944-1974	3.2	97
Australia	1945-1968, 1971, 1978	5.1	48
Belgium	1945-1974	2.5	48
India	1949-1980	1.5	53
Ireland	1965-1990	2.0	62
Italy	1945-1970	5.3	41
South Africa	1945-1974	1.2	43
Sweden	1945-1965, 1984-1990	0.9	36
United Kingdom	1945-1980	3.6	48
United States	1945-1980	3.2	25

Source: *The return of financial repression*, Reinhart 8



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Low interest rates

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Working parties
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Professional support
Enterprise and risk
Learned society
Opportunity
International profile
Journals
Support

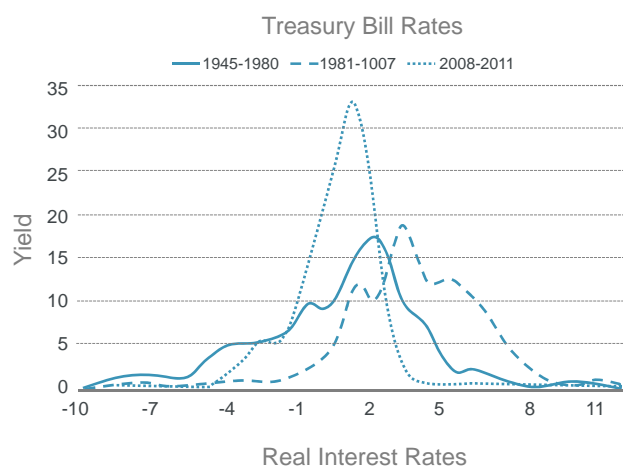
Caps on interest rates

- Explicit regulation
e.g. Regulation Q in the US prohibited banks from paying interest on demand deposits and capped interest on saving deposits
- Caps on bank's lending rates
 - Fixed coupon rate nonmarketable debt
 - Central bank interest rate targets
- Quantitative Easing
- Forward Guidance



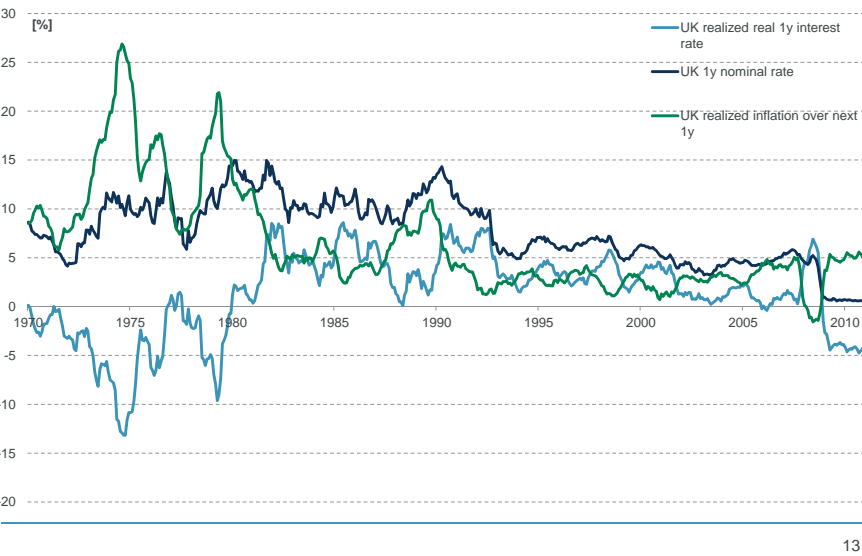
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Real interest rates US



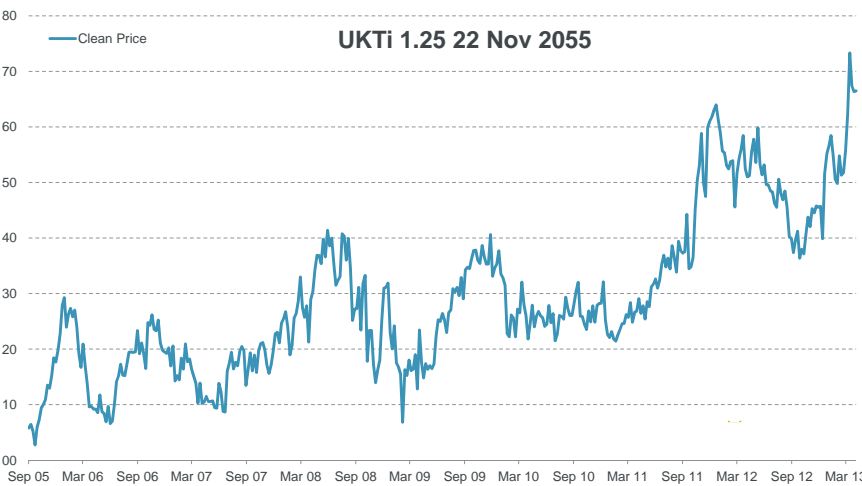
Source: The return of financial repression, Reinhart 12

Real interest rates in the UK (1y)



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Why would anyone buy?



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Quantitative Easing

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Impact of QE on gilt yields

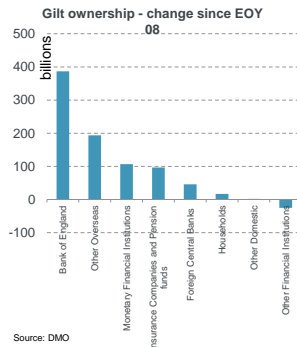
- QE reduces yields
 - “QE has caused the price of gilts to rise and yields to fall” and “The results... around 100bps fall” Bank of England, July 2011
 - “One of the effects of QE is to push up the market price of government bonds and consequently to push down the yield they give investors.” BBC article, March 2012
 - “...the very low gilt yields which are partly, though not exclusively, the result of QE.” NAPF, *Exceptional times, exceptional measures*, March 2012
- But then again...
 - “UK gilt yields have declined only marginally more than comparable government bond yields in countries where there had been no QE.” Towers Watson, October 2012
 - “There are several ways in which large-scale central bank purchases of government bonds can put upward pressure on their yields.” Capital Economics, April 2013
 - “Far from being expansionary, QE is actually contractionary and deflationary.” Ken Fisher, Chief Executive of Fisher Investments, FT article, April 2013



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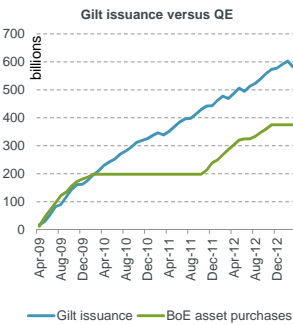
Impact of QE on gilt yields

- The BoE has been the largest buyer
- ...but other buyers are larger in aggregate



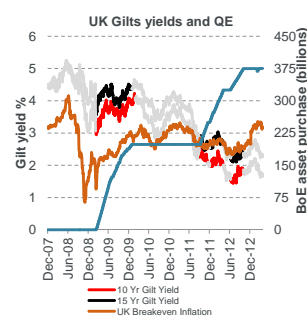
- Pension schemes and insurance companies saw GBP100bn increase
- Has risen at 3x the rate of pre-crisis
- Overseas buyers not deterred by low yields

- QE at times equivalent to new issuance
- ...but not more



- Little evidence of crowding out
- Long periods without QE

- Gilt yields have risen during periods of QE
- QE seems to raise inflation expectations

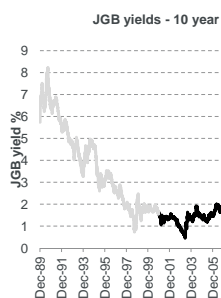


- BoE analysis based only on the few days after announcements
- Choosing the data to fit their conclusion?
- Also, yields moved on US QE2 when BoE did none

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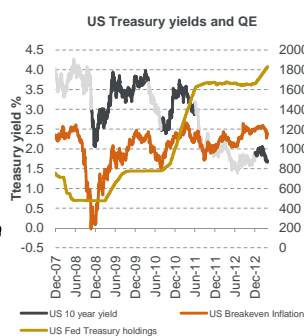
Impact of QE on gilt yields

- Japanese experience has been the same
- ...yields only fell when there was no QE



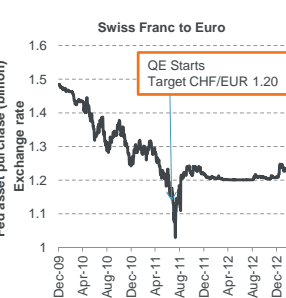
- Yields now higher than when Abe announced recent plans

- US experience has been the same
- ...yields rose until "QE unlimited"



- Since "QE unlimited" was announced, yields have started to fall
- Earlier rises appear driven by rising inflation expectations

- Swiss QE has been effective
- ...but then it had a specific target



- Swiss said "unlimited" at outset
- Is an open ended commitment essential?

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Impact of QE on gilt yields

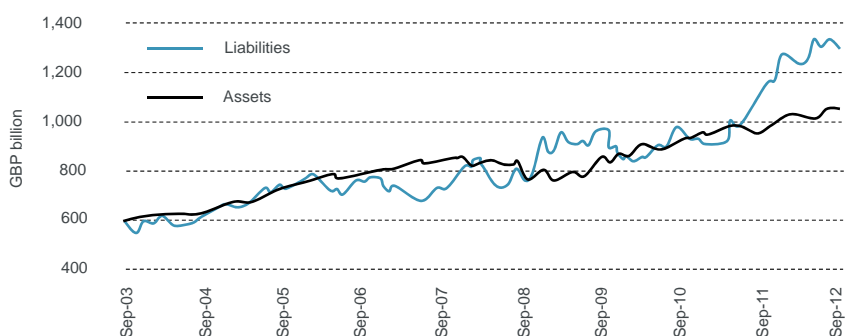
- Do not jump to convenient conclusions
 - There are rational explanations for QE either decreasing or increasing bond yields
 - Buying on rumour could support the former view, but is hard to prove
 - The evidence suggests the latter view has held more often
 - The form and target of QE matter
- Yields have fallen...
 - ...but it is impossible to prove what, if any, was due to QE
 - Look elsewhere for answers as to why yields have fallen

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Impact of low rates on insurers and pension funds

The insurance industry and pension providers have as their first concern the return of the economy to health; however...

Defined Benefit Scheme Assets and Liabilities



Liabilities are measured on a s179 basis.



Source: The Purple Book 2012 PPF/The Pensions Regulator 20

Impact of low rates on insurers and pension funds (2)

- Scheme Funding implications and impact on sponsors
- Individual annuity prices and fund values
- Investment decisions and balance sheet impacts for Life Insurers
- General Insurance underwriting profit margins



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Impact of low rates on insurers and pension funds (3)

Defined Benefit Schemes (cont.)

- Higher recovery payments for sponsor just at a time when it may find hardest to afford. Possible weakening of on-going business prospects and/or jeopardise ability to continue to support the scheme.
- TPR suggested in a statement released in April 2012 "Pension scheme funding in the current environment" that it would exercise understanding in the current challenging conditions.
 - Suggests it may be acceptable to adopt a "rate reversion" margin in the recovery plan assumptions if i) Trustees acknowledge the increased reliance on the sponsor, and ii) monitor assumption of rate reversion against reality (with contingency plans in place).
- Scheme Trustees are faced with higher gilt prices, making it costly to pursue a matched strategy.
 - Adopting a riskier investment strategy may place more reliance on the sponsor and lead to a greater PPF levy
 - Targeting long term goal of buy-out more expensive.

Defined Contribution Schemes

- Increased annuity prices from low rates
 - Impact may be dampened for those very close to retirement if in a lifestyle investment fund.
- Low or negative investment returns, especially if purchasing index linked UK gilts
- Members may have benefited from the rise in equity prices over 2009-2012



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Impact of low rates on insurers and pension funds (4)

Life Insurance

- Inflated gilt prices have pushed investment strategy towards alternate investments in search of yield. Investment in corporate bonds and structured credit is more attractive to maintain rates of return.
- Possible balance sheet impacts
 - Higher market risk capital requirements if alternative investment strategy pursued.
 - Lower gilt yield has led to lower assumed reinvestment return and so a deterioration in balance sheet position (greatest impact for deferred products).
 - Cost of annuity rate and investment guarantees increased.
 - Higher longevity capital requirement.
- Fall in perceived value of saving may lead to less pension saving by individuals and consequently less business (Aviva February 2013 survey "Working Lives" suggests that nearly 40% of people will opt out of auto-enrolment)
- Bulk purchase annuity firms impacted by increased DB scheme deficits
 - Possible fall in buyout business as schemes less able to afford. The Aon Hewitt 2013 survey "Global pension risk survey" showed that pension schemes' long term risk reduction goals are now further away.
 - Schemes/sponsors likely to have less funds available so greater need to be competitive to win business: margins squeezed.

General Insurance

- Less investment return on short term liquid investments – need to make underwriting profit



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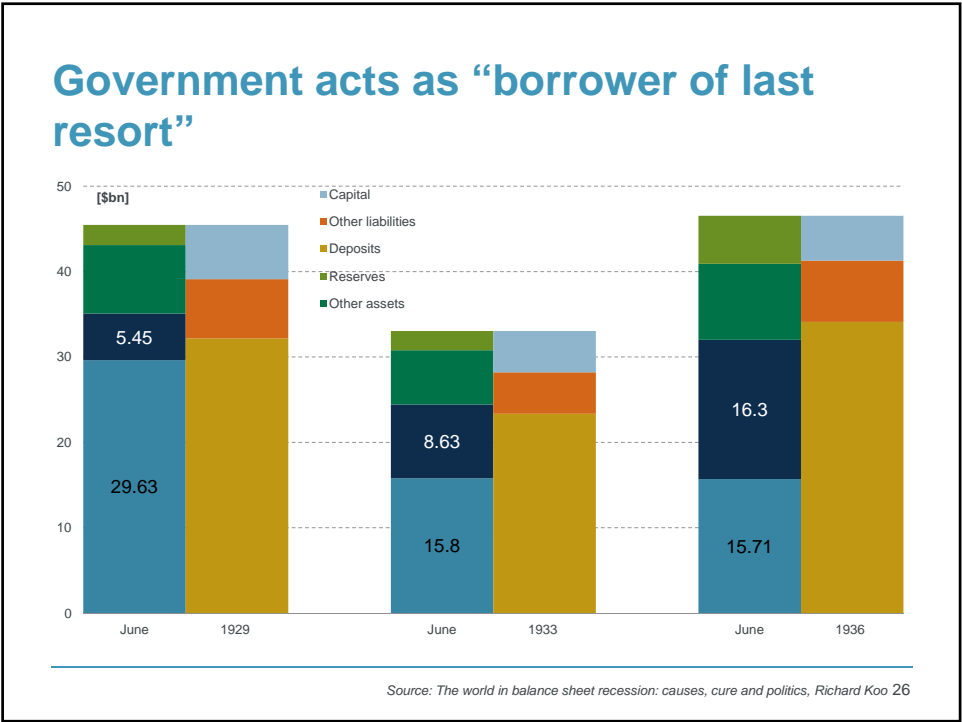
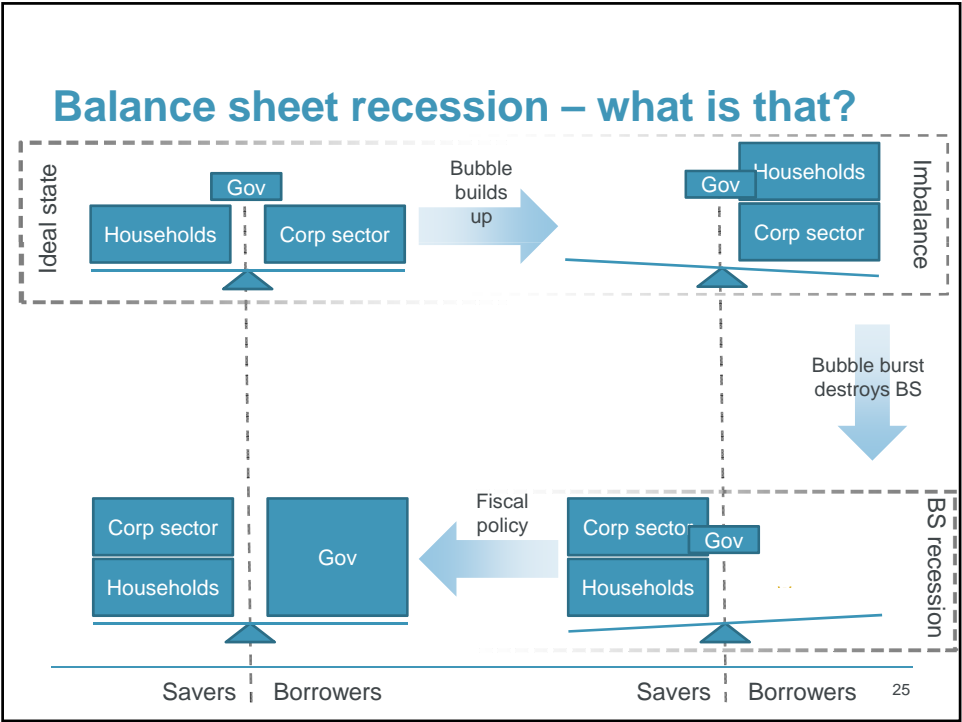


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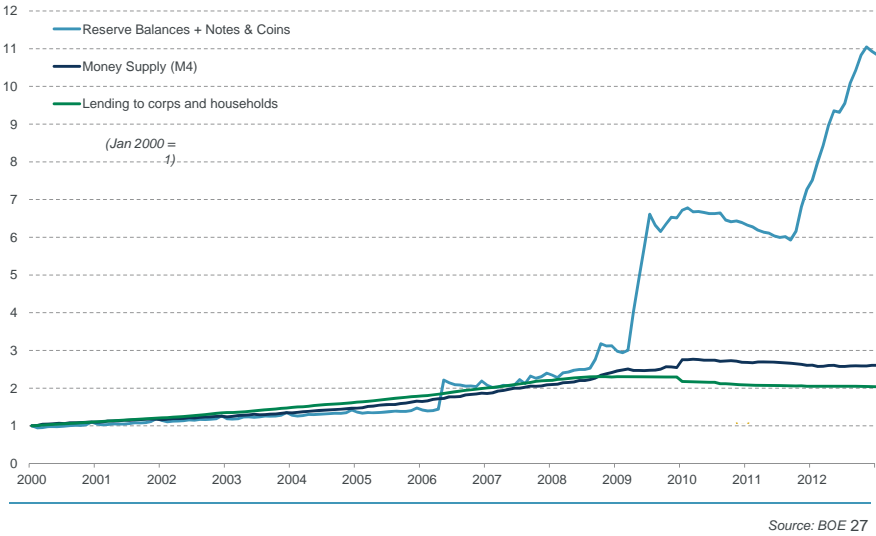
Balance sheet recessions

Lessons from Japan

Expertise
 Sponsorship
 Thought leadership
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Breakdown of money aggregate relationships in the UK



The Ying and Yang economy



	Phenomenon	Fundamental driver	Corporate financial condition	Behavioural principle	Monetary policy	Fiscal policy	Prices	Interest rates	Savings
Yang	Textbook economy	Adam Smith's "invisible hand"	Assets > Liabilities	Profit maximization	Effective	Counter-productive (crowding-out)	Inflation	Normal	Virtue
Yin	Balance sheet recession	Fallacy of composition	Assets < Liabilities	Debt minimization	Ineffective (liquidity trap)	Effective	Deflation	Very low	Vice



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Unconventional²

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Unconventional²

Financially “repressive” schemes

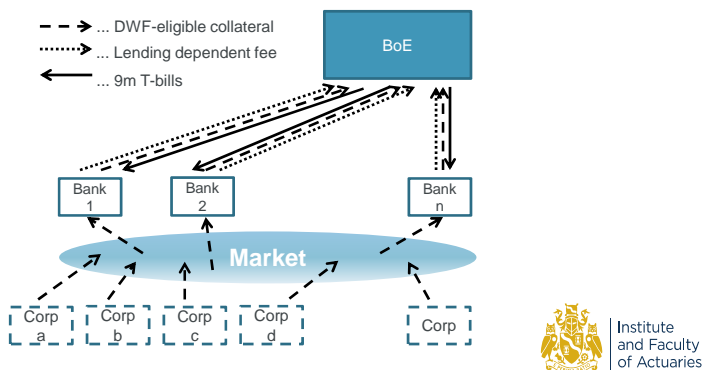
There are other schemes which reduce private sector investment options and effectively encourages investors towards repressive negative “real yield” investment:

- Funding for Lending Scheme
- Help to Buy Scheme
- Business Finance Partnership
- Government underwriting of Housing Association bonds

Each of these schemes reduces options for savers and investors as government is providing cheap finance.

FLS

The BoE provides 9m T-Bills to banks and building societies in exchange for eligible collateral. On maturity, the bills must be returned and can be exchanged for fresh 9m T-bills, allowing funding to occur for up to four years. The paid fee and the amount that a bank can borrow depends on its change in lending.



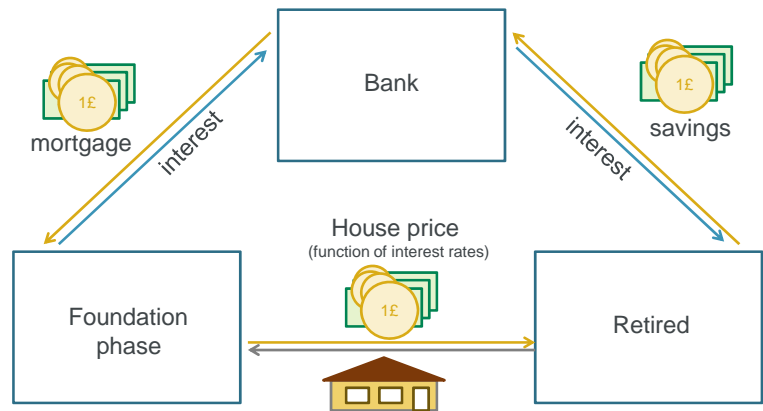
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Funding for lending scheme?

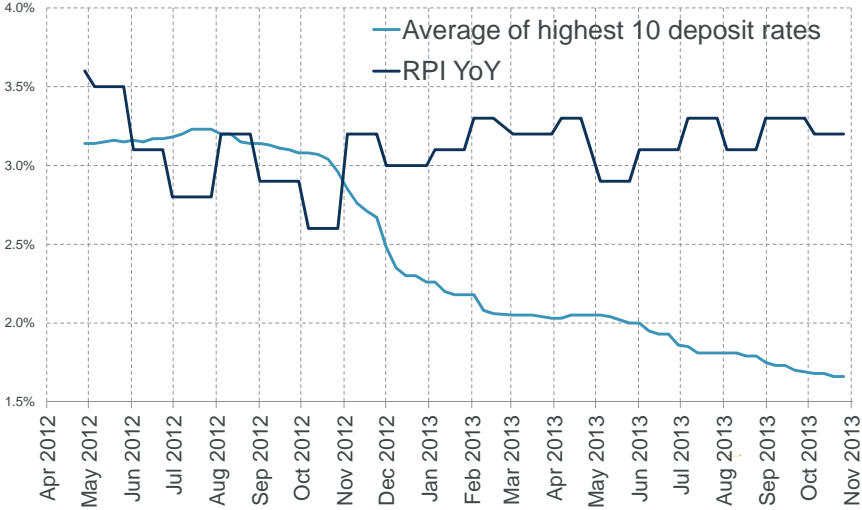
- Is it right for the government to pressure or incentivise banks to increase lending when banks argue that there is low demand for lending from credit worthy applications. This particularly after the over aggressive lending which caused the financial crisis of 2007/8?
- Is it right for government to facilitate lending for residential mortgages and making them artificially cheap, blocking private sector investment?
- Is the weakening of the savings market another form of "repression"?

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The money cycle



Interest rates on UK retail savings



Other currently “repressive” schemes

Support for Housing Associations

- Housing Associations able to borrow money cheaply from Government for social housing.
- This restricts private sector investment into this field as investors cannot compete with the source of cheap money

Business Finance Partnership

- Provides lending to SMEs alongside private sector investment.
- Reduces the returns to investors as it alters the balance of supply and demand for loans

Help to Buy Scheme

- Could this create a housing bubble?
- Shifts emphasis from rental market to home ownership
- What happens when government support is withdrawn?
- Reduces possibility of private sector investment in residential property



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What does the Bank of England say?

“That led to a transfer of wealth to the older generation, which took the form of the younger generation taking out a lot of debt and the older generation having a lot of liquid assets that they got from the proceeds of selling houses.”

Mervyn King, Treasury Select Committee testimony, June 2013

“I have tremendous sympathy for [savers]. But raising interest rates now is not the answer – instead what savers need is a stronger economy. That will mean higher asset prices ... [and] is in all of our interests, as it will deliver better job prospects for our friends, neighbours, children and grandchildren.”

Mark Carney speech on Forward Guidance, August 2013

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A captive audience

Expertise
Sponsorship
Thought leadership
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Learned society
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International profile
Journals
Support

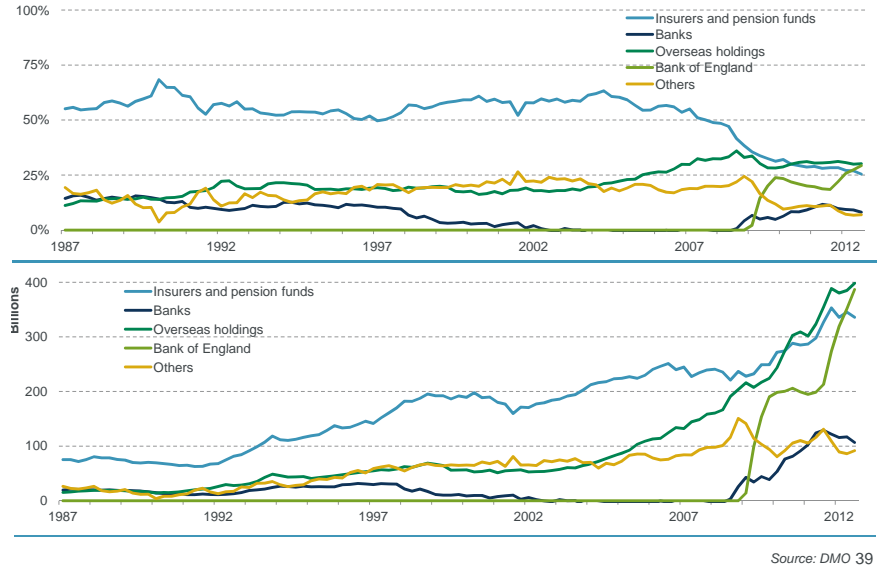
Creating and maintaining a captive domestic audience

- Prudential regulatory measures
- Exchange controls
- High reserve or liquidity requirements (tax levy on banks)
- Transaction taxes
- Prohibition of gold transactions

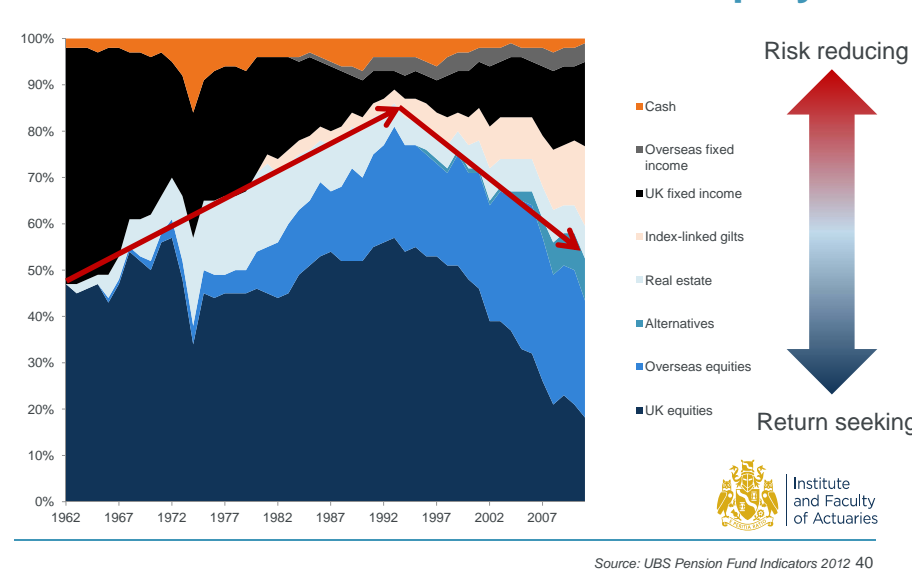


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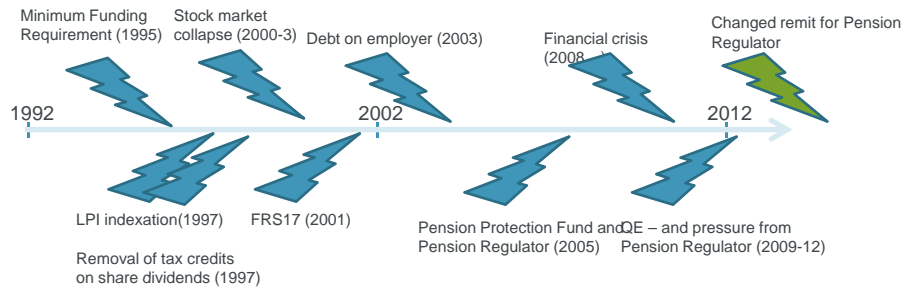
UK gilt holdings



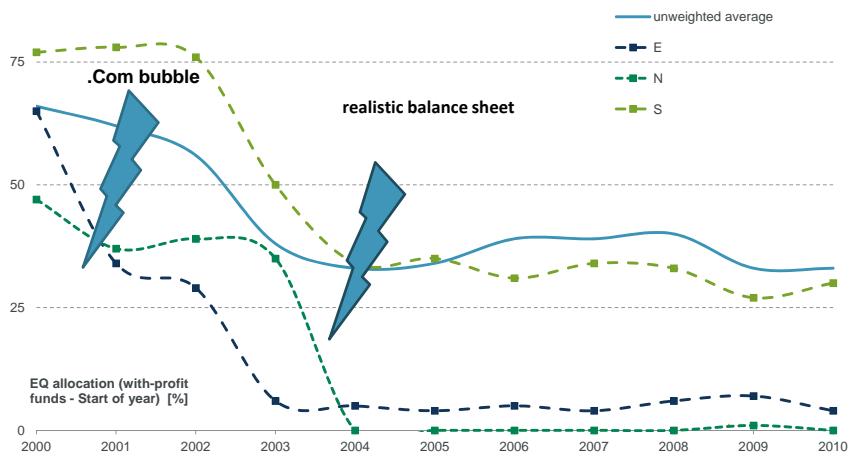
The rise and fall of the cult of the equity



Drivers of the reversal



And life insurers?



Irish precedent

- National Pension Fund used to bail out banks
- Private pension fund tax
- Sovereign annuities



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Secular stagnation

"... prior to the crisis... many people believe that monetary policy was too easy. Everybody agrees that there was a vast amount of imprudent lending going on"

"Was there a great boom? Capacity utilisation wasn't under any great pressure; unemployment wasn't under any remarkably low level; inflation was entirely quiescent, so somehow even a great bubble wasn't enough to produce any excess in aggregate demand."

Larry Summers

"I wonder if a set of older ideas...'secular stagnation'...may not be without relevance to America's experience."

"Back in the day, Hansen stressed demographic factors: he thought slowing population growth would mean low investment demand. Then came the baby boom."

Paul Krugman



Discussion points ...

- What's the lesser evil: financial repression or market crashes?
- Why would anyone buy assets with negative real yields - are pension funds and insurers overly influenced by regulation?
- Has the main impact of unconventional monetary policies been to repress retail savings – and is this a good thing?
- Are savers unfairly paying for the past excesses of borrowers?
Or is savings – rather than investment – a vice rather than a virtue?
- What's the interaction with demographics - are low rates necessary to redistribute the baby-boomer's wealth to a younger generation?
- Confusion or conspiracy – is this a deliberate strategy, or the result of an accidental interaction of monetary policy and regulation?



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Questions

Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenter.



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Appendix

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Sponsorship
Thought leadership
Progress
Community
Sessional Meetings
Education
Working parties
Volunteering
Research
Shaping the future
Networking
Professional support
Enterprise and risk
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Opportunity
International profile
Journals
Support

Working party members

- ***Paul Fulcher (chairman)***
- ***Richard Boardman***
- ***Ian Collier***
- ***Hans-Christof Gasser***
- ***Rod Price***
- ***Paul Shelley***
- ***Sarah Softley***



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Recommended further reading

- **The Liquidation of Government Debt**
Reinhart and Sbrancia; 2011; National Bureau of Economic Research
<http://www.nber.org/papers/w16893>
- **The Return of Financial Repression**
Reinhart; 2012; Centre for Economic Policy Research
<http://www.cepr.org/pubs/dps/DP8947.asp>
- **The world in balance sheet recession: causes, cure and politics**
Richard Koo; 2011; Nomura Research Institute
<http://rwer.wordpress.com/2011/12/12/rwer-issue-58-richard-koo/>
- **Investment Practice – Full Circle?**
Alastair Ross Goobey; 2005; The Pension Institute
<http://www.pensions-institute.org/workingpapers/wp0510.pdf>

